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Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Unemployment Compensation Disability Fund (fund) will require a short-term General Fund loan of up to $40 million in December 1985 and January 1986 to pay disability claims. Unless economic and financial conditions change, the fund will also require another General Fund loan of up to $90.4 million in December 1986 to pay disability claims. Based on current estimates, the fund will require these loans because the tax rate, established by a statutory formula, will not generate sufficient monies to pay disability claims.

The Unemployment Insurance Code allowed the Director of the Employment Development Department (department) to increase the 1985 tax rate by .1 percent by the end of October 1984. The director did not exercise his authority to increase the tax rate because both the director and the fund's independent actuaries believed that the fund would have sufficient monies to pay disability claims in calendar year 1985. However, the director and the actuaries were incorrect in their estimates because of an unexpected increase in disability benefits in 1985 and a beginning fund balance in January 1985 that was lower than expected. As a result, the fund will require a General Fund loan of up to $40 million in December 1985 and January 1986 and will require another loan of up to $90.4 million in December 1986 to pay disability claims. If the director had increased the tax rate from .6 percent to .7 percent for 1985, the fund would have an estimated $42.5 million fund balance at December 1985. However, in December 1986, the deficit would be $125.5 million.

BACKGROUND

The Employment Development Department operates the Disability Insurance Program in California. The department, through the Disability Insurance Program, pays cash benefits to individuals who are unable to perform their usual work because of physical or mental illnesses or injuries. Generally, individuals are covered by the program for illnesses and injuries that are not related to their work. However, under limited circumstances, individuals may also be eligible for disability benefits for work-related illnesses or injuries.

The maximum benefit under the program is $224 per week for 52 weeks. The department determines the amount of an individual's weekly benefit and the duration of the claim using the past earnings of the individual. For calendar year 1985, the department estimates that 645,000 disability claims, totaling over $1,226.6 million, will be paid.

The Disability Insurance Program is financed by California workers through a payroll tax collected by employers. The tax workers pay is based on a percentage of the their taxable wages. In calendar year 1985, the tax rate is .6 percent of a worker's taxable wages up to a maximum of $21,900; the maximum contribution by an individual in 1985 is $131.40 (.6 percent multiplied by $21,900). The department estimates that workers will contribute $890.6 million to the Disability Insurance Program in 1985. The department calculates the tax rate using a formula mandated by Section 984 of the Unemployment Insurance Code. (See Attachment A for an explanation of how the tax rate is calculated.)

In April 1985, the department became concerned that the fund would become insolvent by the end of 1985. In June 1985, the department confirmed the likelihood that the fund would be insolvent in 1985. For the first ten months of 1985, the department received revenues of $809.4 million and disbursed $1,017.7 million. The October 31, 1985, fund balance was $78.2 million.

SCOPE AND METHODOLOGY

The purpose of this review was to determine the causes of the deficit in the State's Disability Insurance Program. We determined whether the department correctly calculated the tax rate for calendar year 1985. We also reviewed the reasons for the fund's expected insolvency and its need for a General Fund loan. In addition, we reviewed the adequacy of the statutory formula established to maintain the solvency of the fund.

Furthermore, our review included an analysis of the director's discretionary authority to increase the calendar year 1985 tax rate by .1 percent. We determined the potential effects of increasing the tax rate by .1 percent. Finally, we reviewed the director's reasons for not increasing the tax rate.

THE UNEMPLOYMENT COMPENSATION DISABILITY FUND DID NOT GENERATE SUFFICIENT REVENUES TO PAY DISABILITY CLAIMS

Using the statutory formula established to calculate the tax rate, the department will not collect sufficient revenues to pay disability claims in both 1985 and 1986. As a result, the fund will require a short-term loan from the State's General Fund of up to $40 million to pay disability claims in December 1985 and January 1986. Moreover, based on current estimates, the fund will require another General Fund loan of up to $90.4 million to pay 1986 disability claims. The fund did not generate sufficient revenues to pay claims for the following reasons:

- More frequent collections of revenues from employers (accelerated collections) in 1984 caused a reduction in the 1985 tax rate;

- Statutory changes increased maximum weekly benefits and the maximum duration of the weekly benefits, and there was an increase in the number of claims paid in calendar year 1985.

Statutory Formula Used to Establish the Tax Rate

In 1980, the Legislature amended Section 984 of the Unemployment Insurance Code to create a variable tax rate formula for the fund. The purpose of the tax rate formula is to maintain the fund balance between 25 and 50 percent of disbursements, thereby maintaining the financial solvency of the fund.* The law was designed to prevent the fund from developing too large a fund balance and to ensure that the fund has sufficient monies to pay disability claims.

*The fund balance is the amount of money in the fund at a particular time that has not been used to pay disbursements.

The department must establish the tax rate for a calendar year by October 31 of the previous year. The department cannot change the tax rate after it is established in October.

Financial Condition of the Fund

In October 1984, the department established a tax rate of .6 percent for calendar year 1985. Using the tax rate of .6 percent, the department has estimated that it will collect $890.6 million in calendar year 1985; disbursements for calendar year 1985 will be $1,226.6 million. Therefore, disbursements will exceed revenues by over $336 million, and the fund will not have sufficient monies to pay disability claims through the end of 1985. At the end of 1985, the fund will have an estimated deficit of $49.6 million.

Because of the expected insolvency of the fund, a General Fund loan of up to $40 million will be required to pay disability claims in December 1985 and January 1986. The department estimated that the remaining $9.6 million would be paid from revenues collected in January 1986. Furthermore, unless economic and financial conditions change, the fund again will have a deficit in December 1986 and will require another General Fund loan to pay 1986 disability claims. The department has estimated that revenue will be $1,272.5 million and disbursements will be $1,313.3 million in 1986. The estimated deficit in the fund at December 31, 1986, will be $90.4 million.

On December 9, 1985, the Governor ordered the Controller to loan up to $40 million to the fund. Section 16351 of the Government Code permits the Governor to order the transfer of monies from the General Fund to the fund if the fund is insolvent and if the General Fund has sufficient monies to loan. The Disability Insurance Program must repay the loan, with interest, as soon as there are sufficient monies in the fund. Department officials believe that the 1985 loan will be repaid by the end of February 1986.

Our audit of the State's financial statements for fiscal year 1984-85 disclosed no major weaknesses in the department's system for recording revenues and disbursements for the fund. Our review included tests of transactions for revenues and disbursements to evaluate certain controls and to determine whether the department complied with certain statutory requirements. Our tests showed that disbursements of disability benefits were properly authorized, computed, prepared, processed, and recorded. In addition, our tests showed that the department properly recorded and processed tax revenues for the fund. We have not reviewed these activities for July 1985 through December 1985.

Reasons for the 1985 Deficit in the Fund

Collections based upon the tax rate formula specified in the Unemployment Insurance Code will not provide sufficient revenues to pay disability claims in calendar year 1985. The projected deficit in calendar year 1985 is caused by two factors:

- The acceleration of revenue collections increased the fund balance at June 30, 1984, requiring the department to reduce the tax rate for calendar year 1985. The department reduced the tax rate from .9 percent in calendar year 1984 to .6 percent in calendar year 1985, a 33.3 percent reduction in the rate.

- In 1985, the total number of disability claims increased by 25,700 claims (4.1 percent) over claims in 1984. In addition, the total amount of disability benefits increased because statutes changed the maximum weekly benefit and the maximum duration of weekly benefits. Benefits for 1985 increased by $253.2 million (27 percent) over benefits in 1984.

Moreover, collections based upon the formula will not provide sufficient revenues in 1986. Consequently, the fund will require loans from the General Fund to pay disability claims and to avoid insolvency.

Acceleration of the Collection of Revenue

Section 13021 of the Unemployment Insurance Code, effective January 1984, required larger companies to pay disability taxes more frequently. The new law requires larger companies to pay taxes to the Disability Insurance Program as often as eight times per month; the prior collection system required employers to pay taxes monthly. The acceleration in the revenue collections does not change the amount of the disability taxes paid; only the timing of the collections changes.

As a result of the accelerated collections, the department received approximately $90 million before June 30, 1985, that it would otherwise have collected after June 30. Thus, the June 30, 1984, fund balance, which was used to determine the 1985 tax rate, was $328.1 million. If collections had not been accelerated between January 1984 and June 1984, the fund balance at June 30 would have been $238.1 million. The department applied the statutory formula to the June 30 fund balance of $328.1 million and reduced the tax rate by .3 percent. If the June 30 fund balance had been $238.1 million, the tax rate would have been reduced by only .1 percent, and the department would have collected $260 million more than it did in 1985. Therefore, if

collections had not been accelerated, the fund would have had sufficient funds to pay all calendar year 1985 claims without assistance from the General Fund.

Increase in Benefits Paid

Section 984 of the Unemployment Insurance Code did not permit the department, in calculating the 1984 tax rate, to consider the effects on the fund of statutory changes to increase the maximum weekly benefit from $175 to $224 and to increase the duration of the weekly benefits from 39 to 52 weeks. The department used the fund balance and disbursement amounts for June 30, 1984, in the statutory formula to establish the calendar year 1985 tax rate. However, the financial impact of the increased weekly benefits and extended duration of benefits occurred after June 30, 1984, and, consequently, was not reflected in the June 30, 1984, fund balance and the 1983-84 fiscal year disbursements. The increase in the duration of weekly benefits occurred after October 1, 1984, 39 weeks after the effective date of the statute--January 1, 1984. Also, the weekly maximum benefit was increased gradually starting in January 1984. All claims did not receive the increased weekly benefit until September 1984, the date that 1983 disability claims expired. As a result, increases in benefits were not included in the calculation of the calendar year 1985 tax rate.

Finally, the fund will not have an adequate fund balance to pay benefits because of an unexpected increase in the number of new disability claims. The department paid 619,300 disability claims in 1984; in 1985, it will pay an estimated 645,000 claims, an increase of 25,700 claims (4.1 percent) in 1985.

The Department's Position on
the Adequacy of the Formula

Both department officials and the fund's independent actuaries believe that the statutory formula should be changed. These officials believe that the current method to calculate the tax rate did not work adequately during 1984 and 1985. Further, the officials stated that current law allows the tax rate to be "volatile." For example, the tax rate was .9 percent in 1984, it decreased by one-third to .6 percent in calendar year 1985, and it increased by one-half to .9 percent in 1986.

THE DIRECTOR DID NOT EXERCISE HIS AUTHORITY TO INCREASE THE TAX RATE BY .1 PERCENT IN 1985

Section 984(a)(5) of the Unemployment Insurance Code allowed the director of the department to increase the calendar year 1985 tax rate by .1 percent in order to protect the solvency of the fund and to ensure the fund's ability to pay promptly its obligations. The director had until October 1984 to increase the tax rate for 1985.

In 1983, the statute allowed the director the discretion to increase the tax rate in calendar year 1985 because in 1983 the department was concerned that the fund would not have sufficient monies in calendar year 1985 to pay claims if pending legislation passed. The department believed that the pending legislation to increase the maximum taxable wages would require a .3 percent reduction in the 1985 tax rate. A .3 percent reduction would not generate sufficient revenues to pay disability benefits.

Reasons for Not Increasing the 1985 Tax Rate

Using the tax rate formula to establish the tax rate for calendar year 1985, the director set the tax rate at .6 percent of taxable wages. The director did not use his discretionary authority to increase the tax rate by .1 percent. When the tax rate was established in October 1984, the director believed that the tax rate of .6 percent and the existing fund balance would be sufficient to pay disability claims in 1985. Using the October 1984 forecast for the fund, the director estimated that the fund would begin calendar year 1985 with a fund balance of $381.6 million. The director also estimated that the .6 percent tax rate would generate revenues of $895.9 million and that the department would disburse $1,056.5 million in calendar year 1985. According to the director's calculations, the estimated fund balance at the end of the 1985 would be $221 million.

The independent actuaries for the the department agreed with the department's 1984 forecast for calendar year 1985. The actuaries stated that the fund was solvent as of January 1, 1985, and that the fund would remain "adequate" through the end of 1985. Further, the actuaries stated that "Even under a range of adverse conditions, including both a downturn in the economy and a higher rate of disability claims, the fund is projected to be adequate to make benefit payments during 1985."

Both the department and the actuaries were incorrect in estimating the solvency of the fund for calendar year 1985. They estimated incorrectly because they did not foresee that disbursements from the fund would be significantly higher and that the January 1985 fund balance would be significantly lower than they had forecast in October 1984. The department based the October 1984 forecast on actual revenues and disbursements through July 1984 and on estimated revenues and disbursements through December 1985. The department's November 1985 estimate is based on actual revenues and disbursements from January through September 1985 and estimated revenues and disbursements for October through December 1985. The following table compares the October 1984 forecast with the November 1985 estimate.

TABLE 1

THE DEPARTMENT'S OCTOBER 1984 FORECAST COMPARED TO ITS NOVEMBER 1985 ESTIMATE OF UNEMPLOYMENT COMPENSATION DISABILITY FUND BALANCES FOR CALENDAR YEAR 1985 (MILLIONS OF DOLLARS)

	November 1985 Estimate	October 1984 Forecast	Difference
January 1985 fund balance	$ 286.4*	$ 381.6	$ (95.2)
Revenues for 1985	$ 890.6	$ 895.9	$ (5.3)
Disbursements for 1985	$1,226.6	$1,056.5	$ 170.1
December 1985 fund balance	$ (49.6)	$ 221.0	$(270.6)

*This is the actual fund balance at January 1, 1985.

As the table shows, the department was accurate in estimating revenues. However, the department significantly underestimated, by $170.1 million, the disbursements for calendar year 1985 and significantly underestimated, by $95.2 million, the fund balance at January 1985.

Effects of the .6 Percent Tax Rate Compared to the Effects of the .7 Percent Tax Rate

Since the director did not use his discretionary authority to increase the calendar year 1985 tax rate from .6 percent to .7 percent, the fund will have an estimated deficit of $49.6 million at December 1985. To pay disability claims for December 1985, the fund will require a General Fund loan of up to $40 million. The department estimated that the remaining $9.6 million will be paid from revenues collected in January 1986.

Using the statutory formula, the director established a tax rate of .9 percent for 1986. Revenues are expected to be $1,272.5 million; disbursements are expected to be $1,313.3 million in 1986. Therefore, unless economic and financial conditions change, in December 1986 the fund will have a deficit of $90.4 million and will require another General Fund loan to pay disability claims.

If the director had used his discretionary authority to increase the calendar year 1985 tax rate from .6 percent to .7 percent, the fund would have a balance of $42.5 million at December 31, 1985. As a result, the fund would be solvent and would not need to borrow money from the General Fund to pay disability claims in calendar year 1985.

However, using the statutory formula, the director would have established the tax rate at .8 percent for 1986. This tax rate would generate $1,145.3 million to pay disability claims of $1,313.3 million in 1986. Consequently the fund would have a deficit of $125.5 million at December 31, 1986, and would require a General Fund loan to pay disability claims. (Attachment B shows how a .1 percent increase in the 1985 tax rate would have affected the fund balance in 1985 and 1986.)

As Table 2 illustrates, the department would require General Fund loans to pay disability claims whether or not the director had increased the tax rate.

TABLE 2

EFFECTS OF THE .6 PERCENT TAX RATE COMPARED TO THE EFFECTS OF THE .7 PERCENT TAX RATE

	Tax Rate of .6 Percent	Tax Rate of .7 Percent
December 1985 fund balance	$(49.6 million)	$ 42.5 million
1986 tax rate	.9 percent	.8 percent
December 1986 fund balance	$(90.4 million)	$(125.5 million)

CONCLUSION

The Unemployment Compensation Disability Fund will require a General Fund loan of up to $40 million to pay disability claims in December 1985 and January 1986. Further, based on current estimates, the fund will require another General Fund loan of up to $90.4 million to pay 1986 disability claims. The insolvency of the fund will occur because the department, using the statutory formula, did not establish a high enough tax rate to generate sufficient revenues to pay disability claims.

The Director of the Employment Development Department did not use his discretionary authority under the Unemployment Insurance Code to increase the 1985 tax rate from .6 percent to .7 percent. As a result, the fund will require a short-term General Fund loan of up to $40 million and will require another loan for 1986 disability claims. If the director had increased the tax rate from .6 percent to .7 percent, the fund would have an estimated $42.5 million fund balance at December 1985; however, using a .7 percent tax rate in 1985 would have caused a deficit of $125.5 million at December 1986. Eventually, the department would require a General Fund loan to pay disability claims.

RECOMMENDATIONS

The Employment Development Department should propose a new tax rate formula for the Disability Insurance Program. The new tax rate formula should provide sufficient revenues to pay disability claims and to maintain a sufficient fund balance in the Unemployment Compensation

Disability Fund to cover unexpected increases in disbursements or decreases in revenues. In developing the formula, the department should consider relevant economic indicators. Also, the department should determine whether the director should have the discretionary authority to change the tax rate. The department should submit its proposal to the Legislature by March 1986.

The Legislature should consider the department's proposal and amend Section 984 of the Unemployment Insurance Code to change the tax rate formula. The statutory change should ensure the solvency of the fund.

Sincerely,

Thomas W. Hayes
Auditor General

Attachments

cc: Honorable Alister McAlister, Chairman
Assembly Committee on Finance and Insurance

Honorable Jerry Eaves, Chairman
Subcommittee on Unemployment/Disability Insurance

ATTACHMENT A

THE FORMULA TO CALCULATE THE TAX RATE FOR THE DISABILITY INSURANCE PROGRAM

Using the formula mandated by Section 984 of the Unemployment Insurance Code, the Employment Development Department performs three calculations to determine the tax rate. In its first calculation, the department divides the fund balance at June 30 by the disbursements for the fiscal year ending June 30; the resulting ratio is called the "fund adequacy" percentage. Using the fund adequacy percentage, the department adjusts the previous year's tax rate using the adjustment factors listed in the law. In the second calculation, the department divides the fund balance at December 31 of the previous year by the disbursements of the previous calendar year to determine a ratio at December 31. In the last calculation, the department subtracts the ratio at December 31 from the ratio at June 30; the department uses the resulting ratio to obtain from Section 984 the second adjustment factor to the previous year's tax rate. The following table shows the computation for the calendar year 1985 tax rate.

CALCULATION STEPS FOR CALENDAR YEAR 1985 TAX RATE COMPUTATION

	Formula	Calculation		Ratio
1	Fund adequacy calculation:			
	June 30, 1984 fund balance / Fiscal year 1983-84 disbursements	\$328,066,616 / \$895,265,365	=	36.645%
2	December 31, 1983 fund balance / Calendar year 1983 disbursements	\$130,046,697 / \$860,303,363	=	15.116%
3	Difference between fund adequacy and change in fund size		=	21.529%

Using the adjustment factors specified in Section 984 of the Unemployment Insurance Code, the first adjustment results in no change to the 1984 tax rate while the second adjustment requires a -.3 percent adjustment. As a result of these computations, the department adjusted the 1984 tax rate from .9 percent to .6 percent in calendar year 1985.

ATTACHMENT B

THE ESTIMATED QUARTERLY FINANCIAL CONDITION
OF THE UNEMPLOYMENT COMPENSATION DISABILITY FUND
WITH A .7 PERCENT 1985 TAX RATE
JANUARY 1985 THROUGH DECEMBER 1986
(MILLIONS OF DOLLARS)

Quarter/Year	Revenues	Disbursements	Fund Balance
December 1984			$ 286.4
January-March 1985	$310.8	$287.8	$ 309.4
April-June 1985	$285.4	$295.4	$ 299.4
July-September 1985	$225.6	$327.0	$ 198.0
October-December 1985	$160.8	$316.3	$ 42.5
January-March 1986	$340.9	$316.0	$ 67.4
April-June 1986	$333.3	$324.8	$ 75.9
July-September 1986	$274.6	$340.8	$ 9.7
October-December 1986	$196.5	$331.7	$(125.5)